66-SBE-015

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
GEORGE R. AND HELEN C. NEWHOUSE, ET AL.)

Appearances;

For Appellants: Neil D. McCarthy, Attorney at Law, and Harry Burke, Certified Public Accountant

For Respondent: Crawford H. Thomas, Associate Tax Counsel

O P I N I O N

These appeals are made pursuant to sections 18594 and 19059 of the Revenue and Taxation Code from the action of the Franchise Tax Board on protests against proposed assessments of additional personal income tax and in denying claims for refund of personal income tax, for the year 1959, as follows:

Appellant	Assessments	Claims for Refund
George R. and Helen C. Newhouse	$1,460.90	$2,159.41
John L. and Geraldyne A. McCarty	207.06	209.34
Warren F. and Dorothy H. Betts	1,044.23	1,257.96
Harry L. and Dorothy Burke	81.00	153.76
William M. and Dorothy Alberts	1,515.78	2,159.41
David J. and Mary R. Duncan	235.88	259.88
James F. and Theo Taylor-	1,505.70	1,697.38
Roy M. and Jeanne D. Good	78.96	88.92
Edwin C. Mohr	469.14	697.88

In 1954 appellants acquired a minority stock interest in the La Ballona Savings and Loan Association (hereinafter referred to as "La Ballona"). Early in 1956, appellants and

another individual purchased the remaining shares of La Ballona from its majority stockholders.

In order to obtain the cash necessary for the Later purchase, a loan was obtained from the Republic Insurance Company under a "warehousing" arrangement whereby it held title to the La Ballona stock as Security,

Appellants'group organized the Biona Corporation (hereinafter referred to as "Biona"), to hold the La Ballona stock. The group acquired the authorized 1,000 shares of Biona at a price of $1.00 per share, On March 25, 1956, the same day appellants' group acquired the remaining La Ballona shares, the minutes of a meeting of Biona's board of directors indicate that its shareholders had offered:

> to sell, assign, and transfer all of their right, title and interest in and to approximately 1,300 shares of the guarantee stock of La Ballona Savings and Loan Association ... in consideration of this corporation assuming the obligation of the named individuals with Republic Insurance Company under *the existing* "warehousing" contract, the obligation of the named individuals with the Security First National Bank of L. A,, Culver City Branch, in the amount' of approximately $40,000.00 and the payment of the following sums to the persons indicated..,, The sums payable to the individuals ...*to* be made pursuant to the terms of the promissory' notes to be issued as evidences of indebtedness calling for the payment of the principal sum in full on or before 3/31/66 and the unpaid balance to carry interest at 6 percent per annum,

On or about March 31,1956, Biona issued unsecured notes, in the total amount of $425,587, calling for payment of principal on March 31, 1966, *together* with 6 percent interest, The notes provided that the maker reserved the right to pay all or any part of the principal prior to the due date without penalty, The La Ballona stock transferred included shares acquired in 1954 as well as those purchased in 1956. Information contained in appellants' 1959 tax returns indicates that the notes were received by each of them in proportion to their respective stock interests in Biona,

The entry recording this transaction on Biona's accounts carried the notation "to record purchase of 1369 shares of La Ballona S & L Stock at '$330 per share,,,,"

No payments were made on the notes until August of 1959 when Financial Federation, Inc., acquired all of the stock of Biona and paid in full the notes issued by Biona to its stockholders.

Neither appellants nor Bfona reported any information regarding the transfer of La Ballona stock to Biona on their 1956 California income tax returns, On the advice of an internal revenue agent who had audited Biona, appellants reported the transaction on their 1957 and 1958 returns as an installment sale on which no payments had been received, In their 1959 returns, appellants reported the entire gain realized upon payment of the notes as long term capital gain received in that year, treating the 1956 transaction as a nontaxable exchange,

The Franchise Tax Board's assessments are predicated on its determination that the 1956 transaction was a sale resulting in short term capital gain on the La Ballona shares acquired in 1956. Respondent further determined that both the long and short term gain was properly taxable in 1959 under the installment reporting method,

Appellants' claims for refund are based on their contention that if a sale did occur in 1956, the gain was taxable in that year only, a valid election to use the installment reporting method for 1956 never having been made, They ask, therefore, that the entire tax paid in 1959 on the gain from the notes be refunded, Since further adjustments to the year 1956 are barred by the applicable statute of limitations, respondent cannot make offsetting assessments for that year,

Pertinent portions of section 17431 of the Revenue and Taxation Code, subdivision (a), provide that no gain or loss shall be recognized if property is transferred to a corporation solely in exchange for stock or securities in such corporation and mediately after the exchange the transferors are in control of the corporation, Respondent's regulations provide that every person who receives stock or securities of a controlled corporation shall file with his income tax return for the taxable year in which the exchange takes. place a complete statement of all facts pertinent to the nonrecognition of gain or loss upon such exchange, (Cal, Admin. Code, tit, 18, reg. 17431(c), formerly reg.17676(c).)

Interpreting a similar provision, section 351 of the 1954 Internal Revenue Code, the United States Tax Court has' held that the tax-free exchange provision is not applicable to a transaction which is, in fact, a sale, (Charles E. Curry, 43 T.C. 667.) The Tax Court has also stated: that where a taxpayer has initially treated a transaction as a sale, he has the burden of proving that it was actually an exchange. (Harry F.

Shannon 29 T.C. 702.)But in determining the effect of transactions for income tax purposes, form, though of some evidentiary value, isnot controlling, The most important consideration is the substance of such transactions and the true nature of the relationship created thereby, (Emanuel N. Nanny) Kolkey, 27 T.C. 37, aff'd, 254 F.2d 510) Whether the transaction we are now faced with was, in substance, a sale is essentially a question of fact, (Burr Oaks Corp., 43 T.C. 635.)

Respondent's position rests primarily upon the Pacts that Biona recorded the transaction in its minutes and accounts as a sale, that none of the 1956 income tax returns reported the information required by respondent's regulations in the case of a tax-free exchange, and that appellants reported the transaction as a sale in their 1957 and 1958 returns, From these facts, respondent concludes that appellants intended a sale;

The weight to be given the factors relied upon by respondent is counterbalanced, to some degree, by the fact that appellants did not report the "sale" on their 1956 returns, This fact lends support to their contention that they originally considered the transaction to be a tax-free exchange, In any case, these are matters of form rather than substance and are not, in our opinion, controlling,

When a corporation is launched with a small amount of designated capital and its basic assets are transferred to it by its shareholders for notes issued in proportion to the stock held by them, resulting in an ostensibly high ratio of debt to equity in the corporate structure, and where the stockholders must rely on the success of the corporation for payment of their notes, there is a strong inference that the transfer of the basic assets is a contribution to capital rather than a sale. (Burr Oaks Corp., supra; R. M. Gunn, 25 T.C. 424, aff'd 244 F.2d 408. Cf. Arthur M. Rosenthal, T.C. Memo,, Dkt. Nos, 2609-63,2610-63, Sept., 21, 1965.)

Building upon a nominal capital contribution of $1,000, appellants' group transferred the only substantial asset Biona was to have in exchange for unsecured *notes* with a total face value of more than $ 25,000. This created a minimum debt-equity ratio of 425 to 1. The La Ballona stock so transferred was already encumbered and Biona assumed those obligations, along with other obligations of its shareholders amounting to some $40,000, All of those obligations further ballooned the debt-equity structure, While no exact computation has been offered, it appears,, from the information contained in the 1959 returns, that the notes were issued *in* proportion to appellants' respective stock interests in Biona, Appellants' notes were subordinate to the claims of Republic

Insurance Company under the "warehousing arrangement," and payment of the notes was dependent on the success of Biona which in turn depended upon the success of La Ballona, The risk was comparable 'to that in R. M. Gunn, supra, 25 T.C. 242, aff'd 244 F.2d 408, where an established business *was* transferred.

In another Tax Court case, without discussing the 'distinction between a sale and an exchange, it was held *that a tax-free* exchange occurred because the notes received from' the corporation were "securities" within the meaning of the pertinent federal statute, (Camp Wolters Enterprises, Inc., 22 T.C. 737, aff'd, 230 F.2d 555, cert. denied, 352 U.S. 826 [1 L. Ed. 2d 49].) The factors considered relevant were the long terms of the notes (first payments due in five years), the degree of participation and continuing interest in the business on the part of the noteholders, and the similarity of the notes to proprietary interests as compared with cash payments.

The long term requirement specified in the Camp Wolters case is satisfied here, since appellants had no right to any payment of principal for a period of ten years. As noteholders, appellants became inextricably tied up with the success of Biona, They were investors, and their notes were more akin to proprietary interests than to cash payments,

We conclude that the notes received by appellants were either "stock" or "securities" within the meaning of section 17431 of the Revenue and Taxation Code and that the 1956 transfer of La Ballona stock for those notes constituted a tax-free exchange,

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT Is HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of George R. and Helen C. Newhouse, et al., against proposed *assessments* of additional personal income tax for the year 1959, as set forth in the opinion *on file in* this proceeding, be and the same is hereby reversed.

IT IS FURTHER ORDERED, ADJUDGED ANDDECREED, pursuant

to section 19060 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claims of George R. and Helen C. Newhouse, et al., for refund of personal income tax for the year 1959, as set forth in the opinion on file in this proceeding, be and the same Is hereby sustained.

Done at Sacramento, California: this 4th day of January, 1966, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

Attest: _____, Secretary